

INTRODUCTION

The Subcommittees on Taxation and Debt Management and Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance have scheduled a joint hearing on July 19, 1989, on employee stock ownership plans (ESOPs).

This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of present-law tax rules and proposals relating to employee stock ownership plans (ESOPs), including S. 1303 (introduced by Senator Bentsen), S. 1171 (introduced by Senator Dole), and proposals before the House Committee on Ways and Means.

¹ This document may be cited as follows: Joint Committee on Taxation, Present Law and Proposals Relating to Employee Stock Ownership Plans (including S. 1303 and S. 1171) (JCX-34-89), July 19, 1989.

PRESENT LAW AND PROPOSALS
RELATING TO
EMPLOYEE STOCK OWNERSHIP PLANS
(INCLUDING S. 1303 and S. 1171)

Scheduled for a Joint Hearing
Before the
SUBCOMMITTEES ON TAXATION AND DEBT MANAGEMENT
and
PRIVATE RETIREMENT PLANS AND OVERSIGHT
OF THE INTERNAL REVENUE SERVICE
of the
SENATE COMMITTEE ON FINANCE
on July 19, 1989

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION
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DESCRIPTION OF PROPOSALS RELATING TO EMPLOYEE STOCK OWNERSHIP PLANS

A. Present Law

Leveraged ESOPs

Present law generally prohibits loans between a qualified plan and a disqualified person (sec. 4975). An exception to this rule is provided in the case of an employee stock ownership plan (ESOP).

If employer securities are acquired by an ESOP with loan proceeds, the ESOP is referred to as a leveraged ESOP. The ESOP may borrow directly from a financial institution (typically with a guarantee from the employer), or the employer may borrow from a financial institution and in turn lend the funds to the ESOP which then uses them to acquire employer securities. The employer securities are typically pledged as security for the loan. The employer makes contributions to the ESOP which are then used to repay the acquisition loan. Shares that are acquired with an acquisition loan are allocated to the accounts of ESOP participants as the loan is repaid.

In general, the type of employer securities that may be held by an ESOP are (1) common stock of the employer that is readily tradable on an established securities market, or (2) if there is no such common stock, common stock issued by the employer having a combination of voting power and dividend rights at least equal to that class of common having the greatest voting power and that class of common having the greatest dividend power. Noncallable preferred stock is treated as employer securities if such stock is convertible into stock that meets the requirements of (1) or (2), whichever is applicable.

ESOPs are required to pass through to plan participants certain voting rights with respect to employer securities. In the employer has a registration-type class of securities, the ESOP is required to permit each participant to direct the plan as to the manner in which employer securities allocated to the account of the participant are entitled to vote. If the employer does not have a registration-type class of securities, the plan is required to permit each participant to direct the plan as to the manner in which voting rights are to be exercised only with respect to certain enumerated corporate issues, such as the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, and similar transactions as prescribed by the Secretary.

Interest exclusion for ESOP loans

A bank, an insurance company, a corporation actively engaged in the business of lending money, or a regulated investment company may exclude from gross income 50 percent of the interest received with respect to a "securities acquisition loan" used to acquire employer securities for an ESOP (sec. 133). A "securities acquisition loan" is generally defined as (1) a loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities for the ESOP, or (2) a loan to a corporation to the extent that the corporation transfers an equivalent amount of employer securities to the ESOP and such securities are allocable to accounts of ESOP participants within 1 year of the date of the loan (an "immediate allocation loan").

B. Description of Proposals

1. S. 1303--Senator Bentsen²

Limitations on partial interest exclusion

The bill would limit the circumstances in which the partial interest exclusion is available. In general, under the bill, the partial interest exclusion would not apply to a securities acquisition loan unless (1) the ESOP owns at least 30 percent of each class of outstanding stock of the corporation issuing the employer securities or 30 percent of the total value of all outstanding stock of the corporation immediately after the acquisition of the securities acquired with the loan, (2) the term of the loan does not exceed 15 years, and (3) each participant is entitled to direct the plan as to the manner in which shares allocated to the participant's account are to be voted. These requirements would apply to transfers of stock with respect to an immediate allocation loan as well as other types of securities acquisition loans.

The 30-percent requirement is designed to ensure that the ESOP holds a substantial share of the company's stock. After the sale of the stock to the ESOP, the ESOP would generally be required to hold the employer securities for at least 3 years. A 10-percent excise tax would be imposed on the employer sponsoring the ESOP on the amount realized upon disposition if, within 3 years after the acquisition of the employer securities with a loan to which section 133 applies, the ESOP disposes of employer securities and the total number of employer securities held by the ESOP is less than the total number held after the acquisition or the value of the employer securities held by the plan after the disposition is less than 30 percent of the value of the outstanding securities. The excise tax would not apply to certain distributions, such as distributions to plan participants and distributions with respect to certain corporate reorganizations.

A 10-percent excise tax would also be imposed on the amount realized upon disposition if the ESOP disposes of the employer securities before the securities are allocated to accounts of participants and the proceeds from such disposition are not so allocated.

These excise tax rules are similar to the rules that apply to a sale of stock to an ESOP if the seller elects to

² S. 1303 was introduced by Senator Bentsen on July 12, 1989.

defer recognition of gain on the sale (sec. 1042) or claims an estate tax deduction with respect to the sale (sec. 2057).

The bill would provide that, with respect to shares acquired with a section 133 loan, plan participants must be entitled to direct the plan as to the voting of shares allocated to his or her account on all issues. This requirement would apply regardless of whether the employer has a registration-type class of securities. In addition, under the bill, if the shares are convertible preferred stock, the participants must be entitled to direct the voting of such stock as if the preferred stock had the voting rights of the common stock of the employer having the greatest voting power.

Effective date

The bill would generally be effective with respect to loans made after June 6, 1989. However, the bill would not apply to loans made after June 6, 1989, to refinance loans made on or before such date (or to refinance loans described in the next paragraph), if (1) such refinancing loan meets the requirements of section 133 (as in effect before the amendments made by the bill), and (2) the outstanding principal amount of the loan is not increased.

In addition, the bill would not apply to any loan (1) made pursuant to a binding written commitment in effect on June 6, 1989, and at all times thereafter before the loan is made, or (2) the proceeds of which are used to acquire employer securities pursuant to a written binding contract (or tender offer registered with the Securities and Exchange Commission) in effect on June 6, 1989, and at all times thereafter before such securities are acquired.

With respect to the grandfather rule for certain loans made after June 6, 1989, the legislative history would provide that the existence of a written binding loan commitment can be demonstrated, for example, by a combination of documentation by the lender, written communications by the borrower or the borrower's agent (e.g., an investment banker or a broker), and documentation of the borrower showing that the loan was approved by the lender and that the offer to make the loan was received by the borrower. Such documentation would have to include the principal terms of the loan, such as the principal amount, interest rate or spread, and maturity of the loan.

2. S. 1171--Senator Dole³

Repeal of partial interest exclusion

The bill would repeal the partial interest exclusion under section 33 for ESOP loans.

Effective date

The bill would generally be effective for loans made after June 6, 1989, including loans made to refinance loans made on or before such date. However, the repeal would not apply to any loan (1) made pursuant to a written binding commitment in effect on June 6, 1989, and at all times thereafter, or in connection with a tender offer, exchange offer or registration statement filed with the Securities and Exchange Commission on or before June 6, 1989, to the extent that the ESOP transaction is described in such documents, (2) used to acquire employer securities which were purchased by the employer on or before June 6, 1989, pursuant to a corporate resolution adopted or before June 6, 1989, providing for the sale of the employer's securities to an ESOP, (3) if a public announcement of the ESOP plan was made by the employer on or before June 6, 1989, setting forth the amount or value of the employer securities to be contributed to the ESOP, or (4) the employer reached an agreement in principle with its lenders, which agreement was evidenced by a written confirmation on or before June 6, 1989, setting forth the principal amount, interest rate or spread, and maturity of the loan.

3. House Ways and Means Committee Action⁴

Limitation on partial interest exclusion

The House Committee on Ways and Means agreed to limit the availability of the partial interest exclusion to situations in which the ESOP owns, immediately after the sale, at least 30 percent of each class of outstanding stock of the employer or 30 percent of the total value of all outstanding stock of the employer. The interest exclusion ceases to apply if the percentage ownership of the employer by the ESOP falls below 30 percent at any time. In addition,

³ S. 1171 was introduced by Senator Dole on June 13, 1989.

⁴ This is a summary description of action taken on July 12, 1989, by the House Committee on Ways and Means in its markup of revenue reconciliation provisions.

the Ways and Means Committee agreed to repeal Revenue Ruling 89-76, relating to publicly traded ESOP debt.

The provision would generally be effective for loans made after July 10, 1989, including loans made after such date to refinance loans made on or before such date. However, the provision would not apply to any loan pursuant to a written binding commitment in effect on July 10, 1989, and at all times thereafter before such loan is made. This exception would apply only to the extent that the proceeds of such loan are used to acquire employer securities pursuant to a written binding contract (or a tender offer registered with the Securities and Exchange Commission) in effect on July 10, 1989, and at all times thereafter before such securities are acquired.

Further, the provision would not apply to loans made to refinance loans made on or before July 10, 1989, or to loans made to refinance loans made after such date and that are grandfathered under the rules described above if (1) the outstanding principal of the loan is not increased by the refinancing, (2) the original lender was a lender that qualifies for the interest exclusion under section 133, and (3) the term of the loan is not extended, or the total period of the loan (including the term of the original loan and the refinanced loan) is not more than 7 years.

As under S. 1303, the legislative history would provide that the existence of a written binding loan commitment can be demonstrated, for example, by a combination of documentation by the lender, written communications by the borrower or the borrower's agent (e.g., an investment banker or a broker), and documentation of the borrower showing that the loan was approved by the lender and that the offer to make the loan was received by the borrower. Such documentation would have to include the principal terms of the loan, such as the principal amount, interest rate or spread, and maturity of the loan.

Other ESOP provisions

In addition to the action taken with respect to the partial interest exclusion, the Ways and Means Committee also agreed to take the following action relating to ESOPs: (1) provide that deferral of recognition of gain on the sale of employer securities to an ESOP would be available only if the taxpayer held the securities for 3 years before the sale to the ESOP; (2) repeal the deduction for dividends paid on employer securities held by an ESOP (sec. 404(k)) unless the ESOP holds at least 30 percent of the stock of the employer; (3) repeal the 50-percent estate tax deduction in the case of certain sales of employer securities to an ESOP (sec. 2057); (4) repeal a provision relating to the assumption of estate tax liability by an ESOP for employer securities acquired by

the ESOP (sec. 2210); (5) repeal special limits on contributions to certain ESOPs (sec. 415(c)(6)); and (6) repeal section 382(1)(3)(C), which provides that stock acquired by an ESOP is not taken into account in determining whether an ownership change has occurred for purposes of determining applicable limits on net operating loss carryforwards following a change of ownership.